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Comptroller of the Currency  
Administrator of National Banks

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Washington, DC 20219

**FINANCIAL MODERNIZATION  
AND BANK SUBSIDIARIES:  
SOUND PUBLIC POLICY**

**June 1998**

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## **Introduction**

Banks play a critical role in our nation's economy and Congress has chosen to implement important public policy goals through banks. Recently a number of initiatives that may profoundly affect the future role and functions of banks have been proposed in the pursuit of financial modernization. The purpose of these initiatives generally is to create a new framework defining relationships between the banking industry, the securities industry and the insurance industry; and with respect to banks, to redefine the activities they are permitted to conduct, directly and indirectly.

Banks are a critical transmission belt of our nation's economy, and Congress uses them to deliver important public policy goals. However, the role of banks has shifted over the years -- and in some ways shrunk -- in response to both competitive forces and to well-intended restrictions that had the effect of hindering bank evolution. One key way to preserve the role played by banks is to enable them to diversify their income to enhance their long-term strength by conducting an expanded range of financial activities. Use of bank subsidiaries is an organizational option that allows banks to pursue such diversification prudently.

While some commentators advocate that banks should conduct certain new financial activities only through a bank holding company (BHC) affiliate, there is no sustainable reason to eliminate the organizational choice of a bank subsidiary. Conducting activities through bank subsidiaries -- subject to the same regulatory safeguards followed by bank affiliates -- enhances bank safety and soundness, helps further public policy goals, and aids in the ability of all banks to compete on a level playing field with each other and with nonbank firms. Domestic and foreign experience with financially related activities conducted in bank subsidiaries shows that such activities enhance rather than detract from the safety and soundness of banks. Furthermore, evidence does not support the contention that activities conducted in bank subsidiaries benefit from subsidies that are not available to BHC affiliates. As a result, claims that the bank subsidiary structure approach is flawed and, therefore, should be prohibited, are misconceived. This paper will address each of these points in turn.

## **The Special Role of Banks**

### ***The Role of Banks in our Economy***

Throughout our nation's history, banks have played a critical role in our economy. As Edward Furash noted, "The purpose of banking is to provide a stable world in which commerce can flourish."<sup>1</sup> Banking is an information-intensive business that provides funding to businesses, and, as such, allows commerce to flourish. Banks are the dominant lenders in markets that require extensive information about borrowers and a continuing monitoring relationship. Indeed, banks are an important source of credit to our nation's small businesses and rural communities.

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<sup>1</sup> Furash, Edward. "Banks are Obsolete -- and Who Cares?" *Proceedings of The Declining Role of Banking*, Federal Reserve Bank of Chicago, May 1994, p.24.

Banks extend more than 60 percent of the dollar value of credit to small businesses.<sup>2</sup> Furthermore, because banks develop long-term relationships with borrowers, they provide an important source of liquidity to firms that may be facing temporary liquidity problems.

Banks are not the only financial services providers to extend loans or take in customer funds, so why is their role in the economy unique? Gerald Corrigan, president of the Federal Reserve Bank of Minneapolis and later the Federal Reserve Bank of New York, characterized banks as having three features that distinguish them from all other financial institutions: “(1) banks provide transaction accounts; (2) banks are the backup source of liquidity to all other institutions; and (3) banks are the transmission belt for monetary policy.”<sup>3</sup>

The late Federal Reserve Chairman Arthur Burns explained further:

Commercial banks serve, in effect, as trustees of other people’s money, and the public interest therefore requires that they be managed prudently. Although they are privately owned organizations, they are the main providers of an essential public service -- that of administering our system for making monetary payments. Commercial banks have also been serving as the conduit for monetary policy -- that is, as the channel through which central banks seek to stabilize national economies. Turmoil in banking has major implications for the public welfare in each of these connections, and that is why all modern governments regulate banking more closely than most economic activities.<sup>4</sup>

A safe and sound banking system is critical to economic stability in times of stress. Similarly, a stable and predictable payments system is a prerequisite for the orderly, efficient conduct of the national economy.

As a result, banks are subject to requirements designed to promote a safe, stable financial and economic system. For example, depository institutions are subject to extensive safety and soundness rules, including stringent capital requirements, restrictions on loans to one borrower,

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<sup>2</sup> Cole, Rebel A., John D. Wolken, and R. Louise Woodburn. “Bank and Nonbank Competition for Small Business Credit: Evidence from the 1987 and 1993 National Surveys of Small Business Finances,” *Federal Reserve Bulletin*, November 1996, p. 984.

<sup>3</sup> Corrigan, E. Gerald. “Are Banks Special?” *1982 Annual Report*, Federal Reserve Bank of Minneapolis, pp. 5-24. All references to Corrigan cite material found at the Internet home page of the Federal Reserve Bank of Minneapolis--<http://woodrow.mpls.frb.fed.us/pubs/ar/ar1982.html>. Also see, Boyd, John H., and Gertler, Mark. “U.S. Commercial Banking: Trends, Cycles, and Policy.” *Macroeconomics Annual*, National Bureau of Economic Research, 1993, pp. 319-68, and Berger, Allen N., Kashyap, Anil K., and Scalise, Joseph M. “The Transformation of the U.S. Banking Industry: What a Long Strange Trip It’s Been,” *Brookings Papers on Economic Activity*, 2:1995, p. 56.

<sup>4</sup> Burns, Arthur F. *The Ongoing Revolution in American Banking*. American Enterprise Institute, Washington DC, 1988, p. 1.

limits on exposure to correspondent banks, and prohibitions on engaging in certain risky activities. Federal banking regulators are also authorized to require banks to engage in corporate-wide contingency planning in order to minimize financial loss, ensure a timely resumption of operations in the event of a disaster, and minimize disruptions of service to business operations or customers (by, for example, obtaining written backup agreements with alternative suppliers). Furthermore, the Bank Protection Act requires federal banking agencies to adopt standards applicable to banks regarding the physical security of premises, the safekeeping of cash and other valuables from robberies, burglaries and larceny, as well as the identification and capture of persons who commit such acts.

### ***The Role of Banks in Implementing Public Policy Objectives***

Throughout our history, banks have also been critical to achieving other important public policy objectives, as determined by Congress, including those related to community development, integrity in the provision of financial services, and consumer protections. This results in the imposition of requirements that are not applied fully or, in some instances, not applied at all to other providers -- including the type of regular examination by regulators that banks experience. The additional requirements banks meet benefit our society in significant ways.

*Banks Provide Community Support.* Banks supply a substantial amount of economic development, resources, and support for America's communities. For example, the Community Reinvestment Act (CRA) provides incentives for banks to help meet the credit needs of all communities in which they operate, including low- and moderate-income neighborhoods. Since the CRA became law, banks have made more than \$410 billion worth of commitments to small businesses and low- and moderate-income consumers (not including, for example, the \$115 billion pledged by Citicorp and Travelers and the \$350 billion pledged by NationsBank and Bank of America, as part of their proposed mergers). CRA applies to FDIC-insured banks and thrifts, but other types of financial services providers are not subject to CRA obligations.

The Home Mortgage Disclosure Act (HMDA) provides the public with home mortgage loan data in order to help regulators identify possible discriminatory lending patterns and enforce anti-discrimination laws. HMDA automatically applies to federally insured banks and thrifts that make mortgage loans, but other financial services providers are not covered automatically.

Unlike other financial institutions, banks have unique obligations to address community needs in connection with closing their branches. Federal law requires that banks adopt policies for branch closings and provide notices before closing any branch (*e.g.*, 90 days advance notice mailed to customers of the branch to be closed and 30 days notice to branch customers via the posting of a sign in the branch to be closed). Only federally insured banks and thrifts are subject to this obligation; it does not apply to other financial services providers.

Lastly, banks that engage in interstate branching under the authority of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 are subject to limitations on how they

deploy funds that they raise. Specifically, that law prohibits banks from using their out-of-state branches to accept deposits from one community to be used primarily for loans in another community. Other types of financial services providers do not face such limitations on how they allocate borrowed funds.

*Banks Enhance Financial System Integrity.* Depository institutions, unlike other financial services providers, are subject to a number of specific laws that ensure that the distribution of credit will be made fairly, without preferential treatment and based on merit. Furthermore, depository institutions face regular examinations to determine their compliance with such laws. For example, the Bank Bribery Act generally prohibits a bank representative from seeking or accepting (and anyone from offering or giving) anything of value in connection with any bank transaction.

Banks are subject to certain limitations and prohibitions on loans to insiders (*e.g.*, any executive officer, director, or principal shareholder of the bank or an affiliate) unless it is made on market terms. In addition, other arms-length requirements are imposed on a bank's relationship with its affiliated companies in order to ensure that transactions are conducted on terms comparable to those that would exist if they were not affiliates.

Federal banking laws also generally restrict an institution's ability to condition the provision of banking products or services on a requirement that a customer also obtain one or more additional products or services from them or from their affiliates (this is referred to as tying). Generally speaking, tougher laws and more vigorous enforcement requirements to combat tying are applied to banking institutions than are applied to other financial institutions, to ensure fairness to consumers and bank competitors.

Finally, the Bank Secrecy Act requires record-keeping and reporting of certain transactions in order to prevent tax evasion and money laundering. While the Act applies broadly to financial institutions and money transmitters, banks and thrifts are subject to more detailed requirements and a rigorous regime of examinations by bank regulatory agencies. This level of detail reflects banks' special role as payment intermediaries.

*Banks Provide Consumer Protections and Disclosures in Deposit and Lending Activities.* Depository institutions are required to purchase (*i.e.*, through assessed premiums) deposit insurance, which protects consumers against a loss of their deposits (up to a statutory maximum amount) in the event of a bank failure. In addition, a number of laws benefitting consumers apply to depository institutions but not to other financial institutions. For example, the Expedited Funds Availability Act imposes a time limit within which a bank must make deposited funds available for withdrawal. The Truth in Savings Act imposes detailed rules governing everything from advertising disclosures and the contents of periodic statements to how depository institutions must calculate the account balance on which interest due is determined. Finally, the Real Estate Settlement Procedures Act requires that mortgage borrowers receive various disclosures (including good faith estimates and final statements of closing costs), places substantive

limitations on the size of required escrow accounts, and generally prohibits payment for the referral of settlement business (e.g., a bank may not pay a real estate agent to refer customers to the bank for a mortgage loan). This Act automatically applies to a bank when making certain mortgage loans but covers certain other financial institutions only if they make more than \$1 million in residential real estate loans within a year.

### ***Long-Term Loss of Competitive Strength***

Well-intended legislative and regulatory restrictions over time have weakened the ability of banks to perform their special functions by hindering their ability to respond to market changes. For example, while other financial services providers have expanded their products or geographic reach, resulting in greater choices for traditional bank depositors and borrowers, banks were long restricted in their ability to offer such choices.<sup>5</sup> Bank customers also have different wants and needs today than in the past, and restrictions hinder banks' ability to respond. Furthermore, technological advances have enhanced the production and distribution of financial services, increasing competition with other financial services providers as well as helping new competitors emerge. As a result, the competitive strength of banks has declined over the long-term.

We see this in several ways. First, as Figure 1 indicates, the market share of assets of all financial institutions held by banks has declined for the last several decades. More and more of what used to be the core business of commercial banking -- lending money to large corporate borrowers -- has declined, as businesses are accessing the capital markets directly (Figure 2). Securities firms also compete with banks more directly by offering loans to businesses.<sup>6</sup> In addition, recent anecdotal evidence suggests that banks have become less competitive relative to finance companies in the origination of automobile loans.<sup>7</sup>

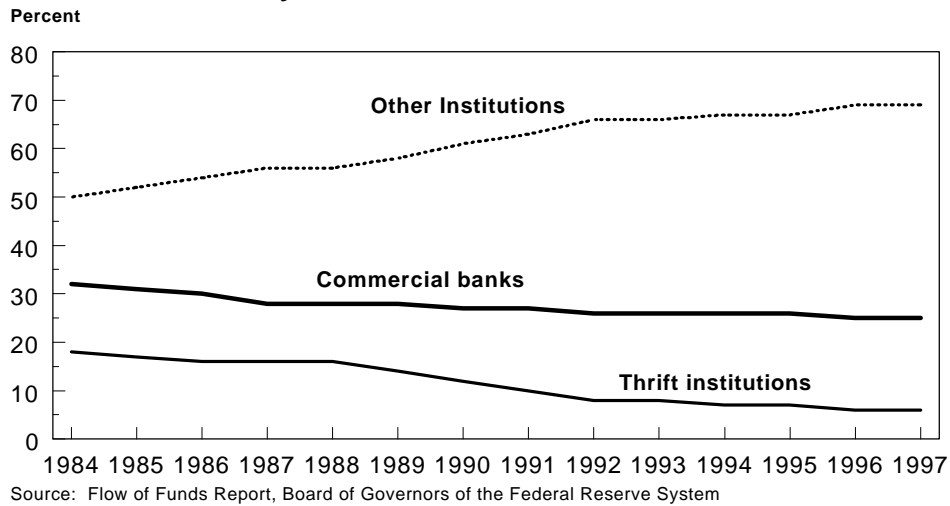
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<sup>5</sup> The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 eliminated the long-term restriction on interstate branching in recognition of the changes in the competitive environment.

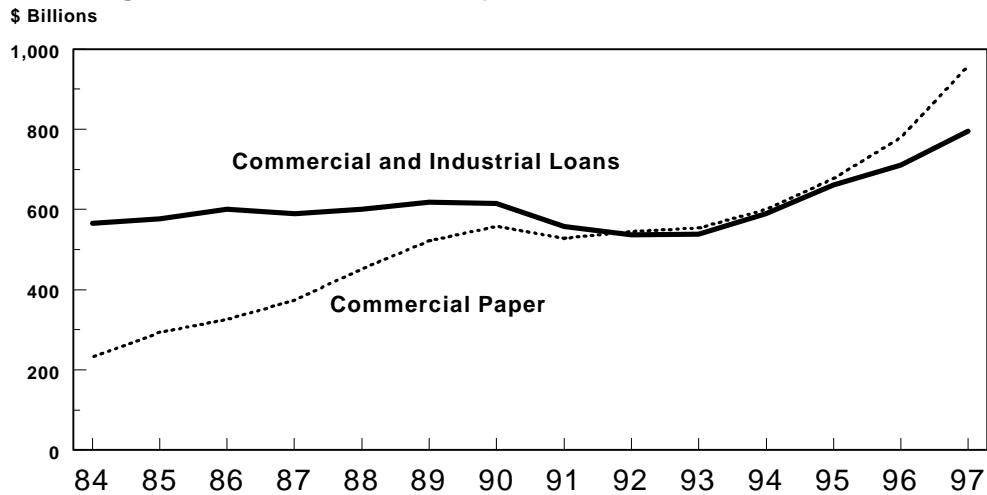
<sup>6</sup> Knecht, G. Bruce. "Merrill Intends to Originate Major Loans," *The Wall Street Journal*, June 20, 1994, pp. A-2. More recently, in early May 1997, Merrill Lynch ran, radio advertisements in the Washington, DC area (5/13/97, 5:55 am, WTOP [1500]) offering working capital loans and other "banking products" to small businesses. For other examples of securities firms offering basic commercial lending services see Ben-Amos, Omri. "DLJ Banks on Junk Power for Lending Business," *American Banker*, June 25, 1997, p. 11. Also, American Express solicits small business loans over the Internet at <http://www.americanexpress.com/smallbusiness/services/lending>.

<sup>7</sup> McQuillen, Daniel. "On-line Auto Lending Seen Offering Banks an Advantage," *American Banker*, May 9, 1997, p. 10.

**Figure 1: Percent of Financial Sectors' Credit Market Assets Held By Commercial Banks Has Declined.**



**Figure 2: Commercial Paper Exceeds Bank C & I Loans**



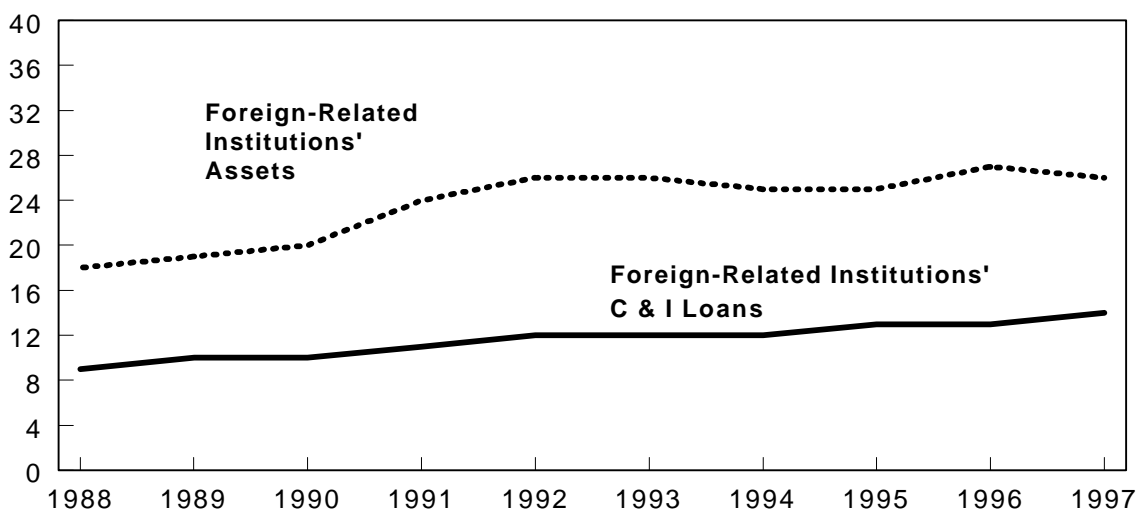
Source: Flow of Funds Report, Board of Governors of the Federal Reserve System and Call Report data.



Next, even without significant legal or regulatory change, economic globalization has made financial services markets increasingly competitive (Figure 3). Within the United States, commercial bank assets held by foreign banks increased from 9 percent in December 1988 to 14 percent in December 1997. Foreign banks' share of total U.S. commercial banks' commercial and industrial loans increased from 18 percent to 26 percent over that same time.<sup>8</sup>

**Figure 3: Foreign-Related Institutions Increase Their U.S. Market Share**

Percent of U.S. Market



Source: H.8, Board of Governors of the Federal Reserve System, "Assets and Liabilities of Commercial Banks in the United States."

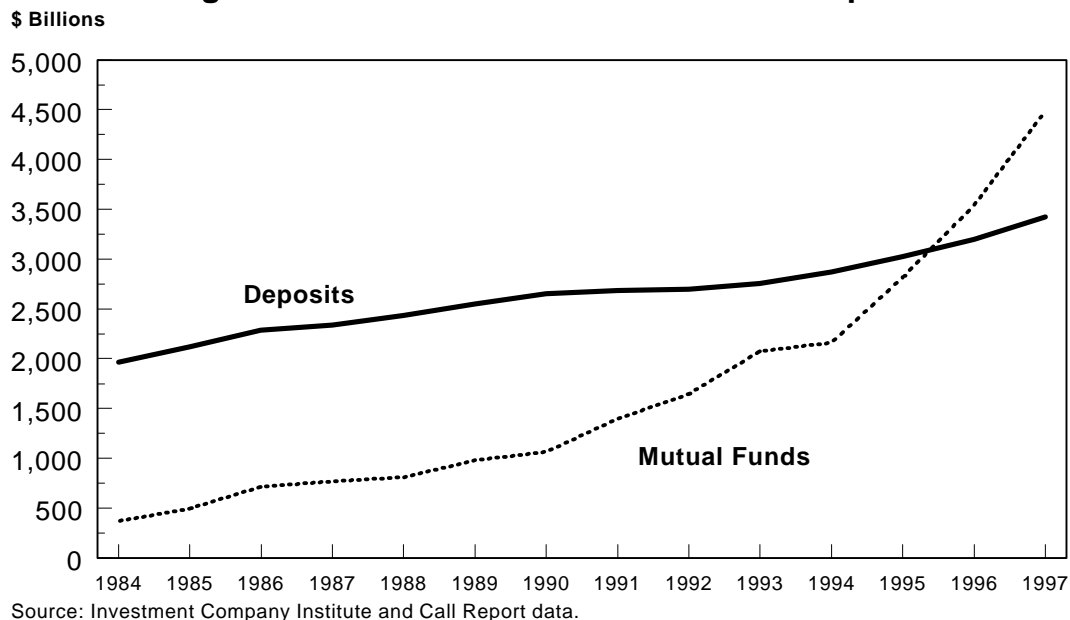
Third, there has been a shift in consumer demand as investors moved their savings from insured deposits to mutual funds that offer an array of investment and risk/reward profiles. In 1996, for the first time in the history of the United States, assets held in mutual funds exceeded assets held in insured deposits, as shown in Figure 4. The percentage of U.S. households owning mutual funds grew from less than 5 percent in 1980 to over 37 percent in 1997.<sup>9</sup>

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<sup>8</sup> Source: "Assets and Liabilities of Commercial Banks in the United States," H.8, Federal Reserve Board.

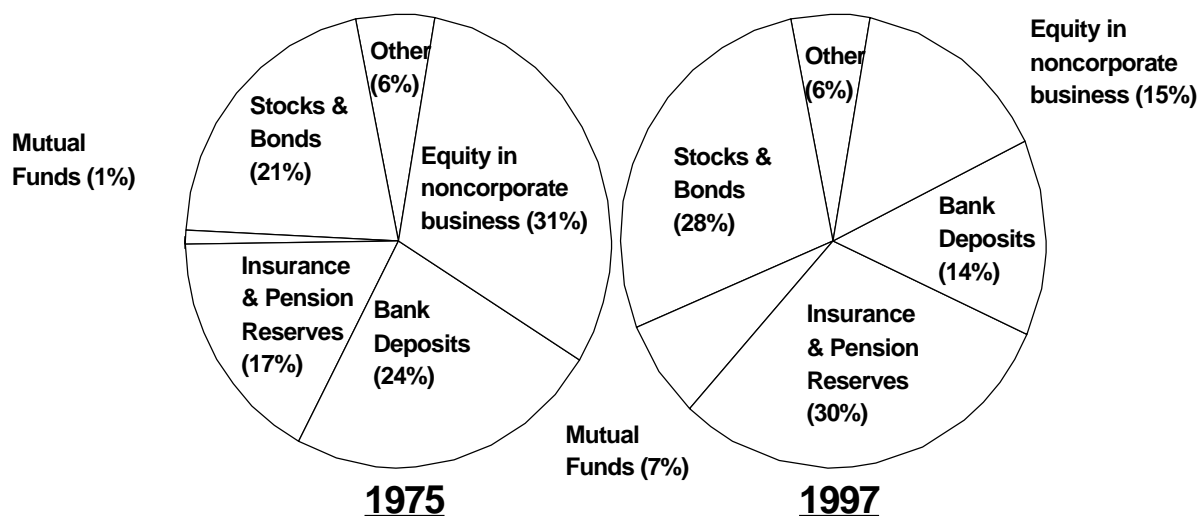
<sup>9</sup> Source: Investment Company Institute.

**Figure 4: Mutual Funds Exceed Bank Deposits**



Furthermore, the percentage of household and nonprofit organization financial assets invested in bank deposits decreased from 24 percent in 1975 to 14 percent in 1997, as shown in Figure 5. This decline indicates a major shift in the primary source of bank funding. Such a shift also represents movement away from liquid transaction accounts.

**Figure 5: Bank Deposits Decline as a Percentage of the Financial Assets of Households and Nonprofit Organizations**



Source: Flow of Funds Report, Board of Governors of the Federal Reserve System.

More recently, because of changing technology, banks face increasingly competitive challenges both within the industry and from nonbanks, including telecommunications companies and software development firms. Edwards and Mishkin have observed that “[a]dvances in information and data processing technology have enabled nonbank competitors to originate loans, transform these into marketable securities, and sell them to obtain more funding with which to make more loans.”<sup>10</sup>

### ***Why We Should Be Concerned***

It is clear that banks have suffered a long-term loss in competitive position as their ability to respond directly to market challenges and adapt has been restricted. Why should Congress and federal policy makers be concerned if banks continue to diminish in relative importance as financial service providers? They should be very concerned because the diminution of the role of banks has implications for economic stability, for economic growth and development and for the implementation of other policy initiatives, especially with respect to communities and small businesses.

Empirical studies have shown that changes in the banking industry affect the economy. Bernanke and James (1991), for example, showed that economic downturns are worse if the banking system is unstable.<sup>11</sup> Furthermore, the long-term loss in bank competitive position weakens the ability of Congress to achieve its public policy goals by using banks as a conduit for policy initiatives. As Furash explained in this discussion of the declining role of banking:

As banks become increasingly less relevant, something must replace them in providing the coordinating and stabilizing functions required in a free market economy. At this point, no such institutional structure has emerged, nor is there one in sight.”<sup>12</sup>

Nor has any other industrialized country developed a substitute for banks. In fact, Furash goes on to argue that although other financial services providers may flourish, “[t]hese emerging entities are neither strong enough nor comprehensive enough to pick up banking’s economic role.”<sup>13</sup>

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<sup>10</sup> Edwards, Franklin R., and Mishkin, Frederic S. “The Decline of Traditional Banking: Implications for Financial Stability and Regulatory Policy,” *Economic Policy Review*, Federal Reserve Bank of New York, July 1995, p.32.

<sup>11</sup> Bernanke, Ben, and Harold James. “The Gold Standard, Deflation and Financial Crisis in the Great Depression: An International Comparison,” in R. Glenn Hubbard, ed., *Financial Markets and Financial Crises*, Chicago, 1991, pp. 33- 68.

<sup>12</sup> Furash, *op. cit.*, p. 25.

<sup>13</sup> Furash, *op. cit.*, p. 29.

From these arguments, he concludes that “this is why we should care about strengthening banking.”<sup>14</sup>

Even a decade before Furash made those remarks at the Chicago Fed’s conference on the decline of banking, Diamond and Dybvig argued that public policy questions surrounding banks were highly relevant: “The important observation is that, even if banks were no longer needed for liability services and if they were constrained from performing their role in controlling the money supply, then important policy questions concerning banks would still arise since banks provide other important services. In other words, the banking system is an important part of the infrastructure in our economy.”<sup>15</sup>

In summary, artificial constraints have prevented banks from adapting to changing market conditions. The role played by banks continues to be important to our economy and public policy concerns. It is costly to our economy to constrain banks unnecessarily and wait for other entities to emerge to fulfill the role played by banks. Instead, the wisest course is to remove unnecessary constraints on the ability of banks to adapt so that banks can continue to compete in the market and serve our economy and our communities.

### **How to Preserve this Critical Role**

#### ***A Remedy for Banking: Prudent Diversification***

It has long been acknowledged that the best way to enhance the ability of banks to provide benefits to the economy and their communities is to allow them to engage in an expanded, prudently defined range of activities, as long as the safety and soundness of the bank is not compromised. In 1987, the FDIC observed that “[t]here is almost universal agreement that something has to be done to allow banks and banking companies to become more competitive in a wider range of markets.”<sup>16</sup> Several years ago, Franklin Edwards and Frederic Mishkin wrote, “To enhance competitiveness and efficiency of financial markets, banks could be permitted to engage in a diversified array of both bank and nonbank services.”<sup>17</sup> Over the past year, several bills have

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<sup>14</sup> Furash, *op. cit.*, p. 25.

<sup>15</sup> Diamond and Dybvig, “Banking Theory, Deposit Insurance, and Bank Regulation.” *Journal of Business*, 59, 1986, p. 62.

<sup>16</sup> Federal Deposit Insurance Corporation. *Mandate for Change: Restructuring the Banking Industry*. 1987, p. vii.

<sup>17</sup> Edwards and Mishkin, *op. cit.*, p 42.

been presented to Congress aimed in one way or another at enhancing the competitive opportunities of banks.<sup>18</sup>

Extensive empirical research demonstrates how diversification is critically important to maintaining a strong banking system. Modern portfolio theory teaches that firms with a diversified portfolio of activities can be financially stronger than non-diversified firms. Conversely, concentrations can hurt banks, depending on the timing of the business cycle. Diversified firms can experience, on average, less variable annual income compared to non-diversified firms. Also, diversified firms can achieve higher annual returns -- but the same variability of returns -- as non-diversified firms.<sup>19</sup> There is an extensive literature on how the theory works in practice for banks, and it supports the belief that diversification is good not only for banks but also for consumers of financial services.<sup>20</sup>

Allowing banks to diversify their financial and financially related activities will make them stronger and produce other benefits of increased competition. This is demonstrated by numerous empirical studies. For example, in a carefully reasoned review of the relevant studies, Silber (1979) calculated that competition from banks in the market for underwriting revenue bonds in 1977 could have saved state and local governments as much as \$370 million.<sup>21</sup> In its 1987 decision to approve the so-called section 20 subsidiaries for bank holding companies, the Federal Reserve Board expressed its belief that banking company entry into new product markets would yield consumer benefits.<sup>22</sup> After evaluating studies of municipal revenue bond underwriting, Pugel and White (1994) concluded that similar savings would accrue to businesses if banks could underwrite corporate securities.<sup>23</sup> Studies of the benefits of bank sales of insurance are limited, but similarly encouraging. Ten years ago, the Consumer Federation of America sponsored such a study and reported that consumers would benefit from increased competition if banks entered the

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<sup>18</sup> H.R. 10 (Representative Leach); H.R. 268 (Representative Roukema); H.R. 669 (Representative Baker); S. 298 (Senator D'Amato).

<sup>19</sup> For a discussion of these points and how they are rooted in the theoretical work of Harry Markowitz, the founder of modern portfolio theory, see, Mote, Larry, R. "The Separation of Banking and Commerce," *Emerging Challenges for the International Services Industry*, JAI Press, 1992, pp. 197-230.

<sup>20</sup> For a review of this literature, see, Mote *op. cit.*, pp. 211-17, and Whalen, Gary. *Bank Organizational Form and the Risks of Expanded Activities*, Office of the Comptroller of the Currency, Economics Working Paper 97-1, January 1997, pp. 5-12.

<sup>21</sup> Silber, William. *Municipal Revenue Bond Costs and Bank Underwriting: A Survey of the Evidence*, New York University Graduate School of Business Administration, Monograph No. 1979-3, 1979.

<sup>22</sup> Federal Reserve Bulletin, Volume 73, April, 1987, p. 490.

<sup>23</sup> See Pugel, Thomas and Lawrence White. "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities," in Ingo, Walter, ed., *Deregulating Wall Street*. New York: John Wiley & Sons, 1994, pp. 93-139.

insurance business.<sup>24</sup> Furthermore, research indicates that bank entry into new geographic markets through branching leads to lower prices for banking services.<sup>25</sup>

### ***The Question of Corporate Form***

While there is high level of agreement that financial diversification is beneficial, extensive debate has ensued regarding the question of corporate form to be used by banks in offering a diversified array of financial products and services. Currently, the debate is whether to allow banks to use bank holding company (BHC) affiliates alone or to enable banks to have the choice to use BHC affiliates and bank subsidiaries.<sup>26</sup> Conceptually, the form under which a private business chooses to operate should be a matter of choice, absent compelling public policy considerations. Thus, the appropriate starting point ought to be that a bank should be free to choose between the two corporate forms unless public policy considerations disqualify one or the other choice. In the course of the recent debate on financial modernization, some have proposed that the use of bank subsidiaries be substantially disqualified. The public policy reasons given are that limiting the choice of organizational form is needed in order to preserve the safety and soundness of the bank or prevent transmission of any safety net subsidy from the bank to a subsidiary. In fact, careful examination of the evidence provided for such claims reveals no public policy reason to limit choice on either basis.

### ***Why Corporate Form Matters***

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<sup>24</sup> See Consumer Federation of America. *The Potential Costs and Benefits of Allowing Banks to Sell Insurance*, 1987.

<sup>25</sup> See, for example, Laderman, Elizabeth S. and Randall J. Pozdena. "Interstate Banking and Competition: Evidence from the Behavior of Stock Returns," *Economic Review*, Federal Reserve Bank of San Francisco, no. 2, 1991, pp. 32-47; Marlow, Michael L. "Bank Structure and Mortgage Returns: Implications for Interstate Banking," *Journal of Economics and Business*, 1982, pp. 135-142; and Calem, Paul S. and Leonard I. Nakamura. "Branch Banking and the Geography of Bank Pricing," Federal Reserve Board, Working Paper 95-25, 1995.

<sup>26</sup> The universal bank model used by other countries is not under consideration. Congress has long recognized the authority of national banks and other member banks of the Federal Reserve System to own operating subsidiaries. For example sec. 23A of the Federal Reserve Act specifically refers to member bank subsidiaries. For OCC authorization of operating subsidiaries see 12 C.F.R. 7.10, 39 *Fed. Reg.*, 11459 (August 31, 1966); *Comptroller's Manual for National Banks*, Paragraph 7376 (Nov. 1996 and Jan 1969 eds.); Interpretive Ruling 7.7376, (1971); and 12 C.F.R. 5.34 (1983 to date). For a detailed legal analysis of national bank operating subsidiaries, see, Williams, Julie L. "Legal Authority for Revised Operating Subsidiary Regulation," as attached to Eugene Ludwig, Testimony before the Subcommittee on Financial Institutions and Regulatory Relief of the Banking, Housing and Urban Affairs Committee of the U.S. Senate. Available on the OCC's Internet website at <http://www.occ.treas.gov>.

*Enhancing Bank Safety and Soundness.* Bank subsidiaries provide a means for the prudent diversification of bank activities, which enhances the long-term strength of banks. In this regard, the diversification of activities through bank subsidiaries enhances bank safety and soundness. Fees and other income from the subsidiaries will enable banks to offset the effects of cyclical downturns in other sectors of the economy. Hence, bank earnings would be less volatile, reducing risks to the banking system as a whole.<sup>27</sup>

By contrast, forcing banks to conduct an array of activities in BHC affiliates only would limit *bank* diversification. Franklin Edwards observed:

With respect to maintaining the financial strength of banks, the use of wholly owned subsidiaries seems superior to that of a bank holding company affiliate structure. The earnings of a bank subsidiary are free to flow directly to the bank, so that subsidiaries would provide banks with a more diversified earnings structure than would the holding company model (where subsidiary earnings flow to the parent rather than to the bank affiliate of the holding company).<sup>28</sup>

The absence of expanded opportunities for banks and their operating subsidiaries will limit their ability to respond to changes in the marketplace and impose unnecessary costs that will render the bank less competitive. Either the assets and income stream of the bank itself will shrink, or the bank will feel pressure to reach ever farther out on the risk curve in “traditional” bank activities to be profitable and generate adequate returns to attract capital.<sup>29</sup> Banks will be less safe and sound, offer fewer choices to customers, be pressured to charge higher fees on the products and services they are allowed to offer, and be less able to serve the financial needs of their communities and their customers.

By enhancing bank safety and soundness, bank subsidiaries also strengthen the deposit insurance funds. Federal Deposit Insurance Corporation (FDIC) Chairman Ricki Helfer noted that “[w]ith appropriate safeguards, having earnings from new activities in bank subsidiaries lowers the probability of failure and thus provides greater protection for the insurance fund than having earnings from new activities in holding company affiliates.”<sup>30</sup> Also, in the event of failure, the assets of the subsidiary are fully available to the FDIC to cover the costs of failure resolution. By contrast, there are no cross-guarantee provisions for nonbank affiliates to assist a troubled

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<sup>27</sup> See, for example, Rose, Peter S. “Diversification of the Banking Firm,” *The Financial Review*, 24, May 1989, pp. 251-280.

<sup>28</sup> Edwards, Franklin R. *The New Finance*, AEI Press, 1996, p. 158.

<sup>29</sup> See, for example, Edwards and Mishkin, *op. cit.*, p. 27.

<sup>30</sup> Helfer, Ricki. “Testimony on Financial Modernization” before the Subcommittee on Capital Markets, Securities, and Government-Sponsored Enterprises of the Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997. Available on the Internet at <http://www.fdic.gov>.

bank, and under Prompt Corrective Action, the amount that a bank holding company or companies can be required to contribute to an ailing bank subsidiary to bring it back into capital compliance is actually limited to a maximum of five percent of the bank's total assets at the time it became undercapitalized.

*Enhanced Implementation of Public Policy Goals.* By enhancing bank safety and soundness, bank subsidiaries also can improve the effective implementation of those laws that are meant to address other public policy goals. The bank subsidiary structure can increase the resources available to support the development and prosperity of all communities, particularly those including lower- and middle-income Americans. Banks have played a vital role in this area historically, and financial modernization must not reduce incentives for institutions to provide broad consumer access to financial services and credit to all sectors of our society.

The Community Reinvestment Act (CRA), mentioned earlier, is a significant program that helps provide consumers access to financial services and credit. The bank subsidiary structure can enhance a bank's capacity for CRA activities. While it is true, as some have pointed out, that bank subsidiaries' and affiliates' lending (and other) activities count toward the CRA performance at the option of the depository institution (thus, CRA does not apply directly to bank subsidiaries or bank affiliates), the OCC explicitly recognizes that, in assessing a bank's ability to perform its obligations under CRA, the assets of the bank and its subsidiaries must both be considered. OCC Bulletin 97-26 provides that, in developing and documenting a national bank's "performance context" in connection with a CRA evaluation, OCC examiners "will review the institution's corporate structure and affiliations, its business strategy and major business products, its targeted markets or communities, its distribution methods to serve those communities, and its financial condition, capacity, and ability to lend or invest in its community."<sup>31</sup>

The consolidated assets of the bank and its subsidiaries are relevant to determining the "bank's capacity to lend or invest in the community." If a national bank subsidiary has significant assets and income, the bank's financial capacity and ability to lend and invest in its community is greater. Since banks are, today, the only type of entity directly subject to CRA, stronger banks, which have greater potential for growth through subsidiaries and, because of greater capacity, face greater regulatory expectations about CRA performance, are better situated to help meet the credit and financial services needs of their communities.

*Promoting Competition and Increasing Efficiency.* Moreover, in order to compete effectively in the financial services marketplace of the future, banks of all sizes need to have the ability to choose the organizational structure that will best enable them to operate efficiently and compete effectively. When faced with the large financial conglomerates that would be authorized under proposed financial modernization legislation, banks of all sizes should not be subject to artificial constraints on their ability to compete. For example, very large financial conglomerates may be able to realize cost savings through the expanded use of technology and economies of scale and

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<sup>31</sup> OCC Bulletin 97-26, July 1997, p. 1



scope. This allows them to absorb costs and trade off inefficiencies resulting from being forced to operate within a particular corporate structure. Smaller banks will not have a similar opportunity to reduce the costs of providing new products and services through a structure that may be inefficient for them.

There are also currently 2,141 independent banks -- i.e., banks without a bank holding company -- representing 23 percent of all banks.<sup>32</sup> Many of these independent banks are community banks facing significant challenges in today's environment. Their sources of income are less diversified than larger banks because they tend to serve smaller communities and market niches. Providing small banks with safe and sound opportunities to strengthen their capacity to compete is clearly in the public interest. For independent community banks, the bank subsidiary option can be simpler and less costly than the BHC structure when providing new products and services. Compared to the BHC affiliate approach, there are fewer corporations, and lower administrative overhead. John Carusone, President of the Bank Analysis Center, has pointed out that the cost of establishing a BHC for a \$103 million bank was about \$35,000, and could be higher for other banks. He also noted that there are ongoing costs such as multiple sets of books and boards of directors.<sup>33</sup> For small banks in particular, these costs are a needless burden, and waste resources that could be better used to make loans and promote economic growth.

Finally, even as bank size increases, the need to keep costs under control remains strong, and the cost efficiencies of the bank subsidiary option remain obvious. In particular, for large banks, the bank subsidiary option can improve their comparative competitive efficiency by providing them with the same organizational flexibility in U.S. and foreign markets as their international rivals, improving the banks' ability to compete more effectively on a global scale.

### ***Why the Arguments Against Bank Subsidiaries Are Misconceived***

Given all of the benefits of the bank subsidiary, it is perplexing to suggest that its use be restricted. Yet, some have portrayed the bank subsidiary as the inferior, riskier organizational choice for the banking system. Such arguments are simply misconceived.

*Safety and Soundness.* There is vast literature comparing bank subsidiaries with nonbank affiliates. There is no evidence that financial activities, subject to basic safeguards, pose greater risk to the bank when they are conducted in a bank subsidiary than when they are conducted in the BHC affiliate. There are a number of experts who have adopted this position. In 1987, the Government Accounting Office opined, "One cannot say that one structure insulates the bank

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<sup>32</sup> As of December 31, 1997. Source: call report data.

<sup>33</sup> Sullivan, Joanna. "More Small Banks and Thrifts Setting up Holding Companies," *American Banker*, June 4, 1997, P. 6. The article did not provide documentation in support of the headline, citing only two institutions, one of which was over a billion dollars in total assets.

while the other does not.”<sup>34</sup> FDIC Chairman L. William Seidman testified before Congress, “If banks are adequately insulated ... then, from a safety and soundness viewpoint, it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks.”<sup>35</sup> In discussing the bank subsidiary option, William M. Isaac, in his role as Chairman of the FDIC, stated that “[c]ertainly there’s no more risk than would be present if the activities were conducted in a holding company affiliate.”<sup>36</sup> Similarly, in a very recent analysis, Longstreth and Mattei found:

...neither structure is so defective, in terms of regulatory objectives, that banking groups ought to be denied the right to use it; that the bank subsidiary model has substantial regulatory advantages over the BHC subsidiary model; [and] that the value of the safety net subsidy is marginal, if not negative, for all but the smallest institutions....”<sup>37</sup> [Assertions that nonbanking activities would cause harm to the bank] are logically flawed -- insofar as they presuppose that a bank would act otherwise than in its own best interest when dealing with a subsidiary -- and fail to give adequate weight to the corporate separateness of bank subsidiaries and the limited liability enjoyed by their shareholders.<sup>38</sup>

More recently, Bernard Shull and Lawrence White concluded that the operating subsidiary structure may be preferable to the BHC affiliate approach in their comparison of organizational structures:

The choice of appropriate banking structure for a world of expanded banks and banking is not an easy one.... [H]owever, both the holding company affiliate arrangement and the operating subsidiary structure appear to be safer than the universal bank for non-traditional activities that are not examinable and supervisable by bank regulators. The operating-subsidiary structure, on the basis of efficiency, diversification, insolvency risk, and transfer of any marginal safety-net subsidies appears to offer modest advantages relative to the holding

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<sup>34</sup> Government Accounting Office. *Bank Powers: Insulating Banks From the Potential Risks of Expanded Powers*, 1987, p. 36.

<sup>35</sup> Hearings before the Senate Committee on Banking, Housing, and Urban Affairs, December 3, 1987.

<sup>36</sup> Isaac, William. “OCC Rule on Subsidiaries is Sound Public Policy,” *American Banker*, December 19, 1996, p. 5.

<sup>37</sup> Longstreth, Bevis, and Ivan E. Mattei, “Organizational Freedom for Banks: The Case in Support.” *Columbia Law Journal*. 97:6, October 1997, p. 1899.

<sup>38</sup> *Ibid.*, p. 1895.

company structure. Accordingly, the op-sub structure as an alternative seems a prudent policy course for U.S. banking regulation.<sup>39</sup>

Although most major industrialized countries have explicit deposit insurance systems similar to the United States, no other country except Japan imposes such significant restrictions on their banks' powers or corporate structure. During the banking problems of the late 1980s and early 1990s, U.S. banking firms did no better than banks in other G-10 countries.<sup>40</sup> This suggests that the tight corporate restrictions imposed by the government in this country are no more effective in limiting risk than the more flexible corporate structures bank supervisors allow in other developed countries.

Domestic experience with financial activities conducted by bank subsidiaries shows that there are no disqualifying safety and soundness concerns. FDIC Chairman Ricki Helfer summarized her agency's experience as follows:

While the experience of the FDIC with bona fide securities subsidiaries of insured nonmember banks has been limited, these subsidiaries generally have not posed safety and soundness concerns. Only one FDIC-supervised institution owns a subsidiary actively engaged in the full range of securities activities permitted by the FDIC, but over 400 insured nonmember banks have subsidiaries engaged in more limited securities-related activities. These activities include management of the bank's securities portfolio, investment advisory services, and acting as a broker-dealer. With one exception, none of these activities has given cause for a significant safety and soundness concern.<sup>41</sup>

Similarly, foreign experience with financial activities conducted by U.S. bank subsidiaries shows no substantial safety and soundness concerns. In a preliminary analysis, Gary Whalen, an Office of the Comptroller of the Currency economist, produced evidence demonstrating that permitting U.S. banking organizations to engage in securities activities overseas through direct and indirect bank subsidiaries has not had a significant, deleterious impact on their performance. This empirical evidence is drawn from an extensive analysis of the performance of the foreign securities subsidiaries of U.S. banking companies over the relatively lengthy 1987-1996 time period. The data analysis, as well as a more detailed examination of the performance of individual

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<sup>39</sup> Shull, Bernard, and Lawrence J. White. "The Right Corporate Structure for Expanded Bank Activities." *Banking Law Journal*, May 28, 1998, pp.446-476.

<sup>40</sup> Barth, James R., Daniel E. Nolle, and Tara N. Rice. "Commercial Banking Structure, Regulation, and Performance: An International Comparison," OCC Economics Working Paper 97-6, March 1997, p. 34.

<sup>41</sup> Helfer, *op.cit.*

holding companies, indicate that banking companies can lower their risk by engaging in overseas securities activities through bank subsidiaries.<sup>42</sup>

*Safeguards.* During the 1997 debate over financial modernization, the Treasury Department proposed an extensive set of corporate and supervisory safeguards to ensure that any new financial activities, conducted in a bank subsidiary that could not be conducted by the bank itself, enhance rather than impair the parent bank's safety and soundness. Under Treasury's proposal, these safeguards would apply regardless of the particular activity undertaken by the special bank subsidiary and generally would provide equivalent protections for activities undertaken by either subsidiaries or affiliates. Also, in many cases, activities would be regulated on a functional basis by another regulator.

The specific safety and soundness safeguards proposed by the Treasury Department would apply to bank subsidiaries undertaking new financial activities that could not be undertaken by the bank itself. These safeguards include the following:

- The bank would have to be well-capitalized and well-managed, and would face sanctions for failing to meet these standards;
- The amount of any equity investment made by a parent bank in a subsidiary would have to be deducted from the bank's capital in determining whether it satisfied the "well-capitalized" standard; and the assets and liabilities of the subsidiary may not be consolidated with those of the bank. Thus, if the subsidiary were to fail, the bank's regulatory capital would not be affected and the bank's economic loss could not exceed the amount of its investment;
- Sections 23A and 23B of the Federal Reserve Act would be applied to transactions between the parent bank and its subsidiary(ies). These provisions prohibit a bank from lending more than 10 percent of its capital to any one affiliate, prohibit a bank's combined loans to all affiliates from exceeding 20 percent of the bank's capital, and require that all loans and other transactions between a bank and its affiliates be fully collateralized and at arm's length, market terms. The Section 23A capital limitations would not apply to a bank's equity investment in a subsidiary;
- Although a bank under current law or proposed legislation can pay dividends to its holding company for an investment in new activity without being subject to Sections 23A and 23B, an appropriate safeguard -- in addition to the requirement that it deduct from its capital its equity investment in the subsidiary -- would

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<sup>42</sup> Whalen, Gary. "The Securities Activities of the Foreign Subsidiaries of U.S. Banks: Evidence on Risks and Returns," Office of the Comptroller of the Currency, E&PA Working Paper 98-2, February 1998

prohibit the bank from making a downstream equity investment in the subsidiary in excess of the amount that it could legally pay out as a dividend;

- The parent bank with a financial subsidiary is required to assure that it has procedures for identifying and managing financial and operational risks within the bank and its financial subsidiary to adequately protect the bank from such risks and assure that it has reasonable policies and procedures to preserve the separate corporate identities and limited liability of the bank and its financial subsidiaries.

Furthermore, it is simply incorrect to assert that the holding company structure better insulates the bank from the risks of new financial activities conducted in an affiliate because courts are more likely to hold the bank liable for activities of a bank subsidiary than for activities of a bank affiliate. In fact, statistics indicate that it is *more difficult to pierce the corporate veil* between a parent and its subsidiary than between that parent company and a sister company (e.g., a bank holding company affiliate).<sup>43</sup> Whether a bank's corporate veil is pierced by a court depends on how the entity's operations were conducted, not on the entity's location in a corporate organizational chart.

Similarly, proponents of the bank holding company approach have asserted that accounting conventions make a holding company affiliate a better choice than a bank subsidiary for conducting new financial activities. One argument is that because Generally Accepted Accounting Principles (GAAP) require consolidation of a bank and its subsidiary's financial statements, national banks would have strong incentives to rescue troubled subsidiaries. It is also argued that subsidiary losses, reflected in the consolidated financial statements, would cause depositors and investors to lose confidence in the bank. These arguments, too, upon close review, are not sustainable.

First, accounting standards do not determine corporate liability; rather they provide a measure of an institution's financial condition. When financial reports are consolidated, companies are reporting their assets and liabilities on a combined basis, but they do not become legally responsible for each other's liabilities. Those statements simply reflect a reporting convention. Second, holding company financial statements also reflect the consolidation of the financial statements of its subsidiary entities. Thus, the same incentives exist for a holding company and its subsidiary bank to bail out their affiliates. Bank holding company statements reflecting financial difficulties could cause equal or greater concern to investors and depositors. Third, accounting rules require the deconsolidation of subsidiary financial statements when a bank no longer controls a subsidiary, when it is ordered to sell or liquidate the company, or when a subsidiary goes bankrupt. At that point, a bank's financial statements would reflect the true economic loss to a bank, which would never be greater than its actual investment in the subsidiary (already deducted from capital) and any limited credit exposure under Section 23A limits.

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<sup>43</sup> Longstreth and Mattei, *op. cit.*, p. 1906

Finally, it can be credibly argued that, to the extent the corporate structure of a bank affects its safety and soundness, safety and soundness is enhanced when the financial and economic interests of the bank and its subsidiaries are more closely aligned. In their analysis of the arguments in favor of organizational freedom for banks, Longstreth and Mattei make the following critical point:

Requiring that activities be conducted in a bank affiliate rather than in the bank introduces its own set of risks that can generically be labeled the risks of self-dealing.... A BHC is in control of its various subsidiaries and may have an incentive to cause them to engage in transactions with each other or with itself that accrues to the BHC's benefit and perhaps one or more of its subsidiaries while at the same time disadvantaging other subsidiaries within the group. When the bank, as one of those subsidiaries, is disadvantaged, its soundness suffers. By contrast, with the bank at the top, the potential for harm to bank soundness from self-dealing transactions is largely eliminated by operations of the structure alone.... With the bank at the top, it is not possible for the bank, through self-dealing, to hurt itself deliberately.<sup>44</sup>

*The Question of the Safety Net Subsidy.* Some contend that the use of bank subsidiaries should be limited because banks allegedly transfer the advantage of a safety net "subsidy" to their subsidiaries.<sup>45</sup> There is no evidence that banks are subsidized in a manner which gives them a special competitive advantage; nor that the BHC structure is uniquely effective in limiting any advantage a bank may gain from access to the federal safety net. The evidence cited below suggests strongly that banks do not benefit from any *net* subsidy. For example, Chairman Helfer of the FDIC stated the following:

... [T]he evidence shows that, if banks receive a net subsidy from the federal safety net, it is small, and that both the bank holding company structure and the bank subsidiary structure would inhibit the passing of any net subsidy that does exist out of the insured bank. Thus, the potential expansion of the federal safety net is not a reason to prefer one organizational structure over the other.<sup>46</sup>

Moreover, the same rules that today contain the transfer of any alleged subsidy by a bank to its affiliates -- Sections 23A and 23B of the Federal Reserve Act -- may be imposed on bank subsidiaries to effectively prevent transfer of any possible subsidy to a subsidiary as well.

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<sup>44</sup> Longstreth and Mattei, *op.cit.*, pp. 1903-04.

<sup>45</sup> The "safety net subsidy" or "federal safety net" refers to the benefits that banks receive through their access to federal deposit insurance, and the Federal Reserve's discount window and payments system. It has been asserted that these benefits give banks a funding advantage over nonbanks and create incentives for banks to take on greater risks.

<sup>46</sup> Helfer, *op. cit.*

Recent legislative and regulatory measures have reduced any gross benefit to banks arising from the so-called federal safety net. Such measures have decreased the amount of benefit accruing to troubled institutions and have increased the cost of safety net features. These measures include the Basle Accord of 1988, in which the regulatory agencies tied regulatory capital requirements to risk and adopted minimum risk-based capital standards; and several provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The provisions of FDICIA include the prompt corrective action provisions that require regulators to close a troubled institution before the book value of its equity reaches zero, reducing the loss to the deposit insurance fund. They also include the least-cost test that requires the FDIC to resolve failed banks at the least cost to the deposit insurance funds, increasing the likelihood that uninsured depositors and other general creditors would suffer losses in the resolution of a failed bank. Similarly, FDICIA greatly limited the ability of the regulators to prevent the failure of large banks, the “too-big-to-fail” policy of the past. Other provisions in FDICIA restricted the terms under which an undercapitalized bank can access the discount window. Legislative and regulatory changes also have reduced any subsidy that could have arisen from inaccurately priced access to the federal safety net by requiring the FDIC to enact a system of risk-related deposit insurance premiums that is based on the financial institution’s perceived level of risk to the insurance fund.

*Empirical analysis demonstrates that regulatory costs outweigh any gross safety net benefit.* The existence of a “subsidy” would imply that banks receive benefits without paying for them. Banks bear significant costs in return for access to the safety net. They are subject to a number of regulations, which impose operational limitations to protect their safety and soundness and to protect consumers. Laws and regulations also govern entry and exit, geographic and product expansion, fiduciary activities, and the quality of internal and external information systems. They also provide measures ensuring equal access to credit.

The costs associated with regulation are direct and indirect; consequently, it is difficult to estimate the total costs accurately. In a study of banking industry data,<sup>47</sup> the Federal Financial Institutions Examination Council estimated that in 1991 banks paid anywhere from 6 percent to 14 percent of non-interest operating expenses to comply with requirements imposed by law and regulation. These cost estimates did not include costs associated with maintaining required reserves or interest payments on FICO bonds.<sup>48</sup> For 1995, the lower bound of the FFIEC estimate would suggest that the aggregate regulatory costs borne by banks was roughly \$9 billion, or 35 basis points, when expressed as a percent of total deposits in insured banks.

*Not surprisingly, banks do not behave as if there is a safety net subsidy.* If a subsidy existed, banks would conduct their business to exploit that subsidy fully and would dominate the

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<sup>47</sup> Federal Financial Institutions Examination Council, “Study on Regulatory Burden,” December 17, 1992.

<sup>48</sup> These costs were estimated at 4.6 basis points by the FDIC. See testimony of Ricki Helfer, Chairman, FDIC, on financial modernization before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises, Committee on Banking and Financial Services, U.S. House of Representatives, March 5, 1997.

markets they seek to serve. Such skewed behavior is not evident in the way banks fund themselves or structure themselves. Nor do banks dominate the businesses in which they are engaged.

For example, if banks enjoy a lower cost of funds because of benefits accruing from the safety net, we would expect to see banking organizations issue debt exclusively at the bank level. Instead, we see debt issuances by banks, bank holding company parents, and nonbank affiliates. Furthermore, if there were a subsidy, banks could take best advantage of it by selling their debt directly to the public. Instead, most bank debt is issued to the parent holding company, which in turn funds this purchase by issuing commercial paper. If the deposit insurance subsidy were important, banks would rely almost exclusively on insured deposits as their source of funds. In fact, less than 60 percent of commercial bank assets are supported by domestic deposits, and some banks hardly use them. As of December 1997, domestic deposits at the 10 largest commercial banks ranged from 6 percent to 88 percent of liabilities. Among the top 10 banks, foreign deposits, which are not insured, currently compose as much as 61 percent of liabilities.<sup>49</sup>

The use of bank subsidiaries and bank holding company affiliates is another area of bank behavior bearing on the subsidy issue. If banks benefited from a subsidy not available to the holding company, banks would locate all activities in bank subsidiaries and not in bank holding company affiliates, when they are permitted to choose between those two options. Again, bank behavior is not consistent with the presence of a subsidy. For example, banks can locate their mortgage banking operations in a bank, a bank subsidiary, or in an affiliate of a holding company. The table below lists activities -- such as consumer finance, mortgage banking, leasing and data processing -- that banking companies offer through both holding company affiliates and bank subsidiaries.

### **Most Common Nonbank Affiliates of Bank Holding Companies**

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<sup>49</sup> Call report data as of December 1997.



**and Subsidiaries of Banks: 1996<sup>50</sup>**

<b>Type of Nonbank Subsidiary</b>	<b>Number of Subsidiaries, Bank Holding Companies</b>	<b>Number of Subsidiaries, Banks</b>
Consumer finance	318	124
Leasing personal or real property	191	365
Mortgage banking	129	201
Data processing	123	96
Insurance agency or brokerage services <sup>51</sup>	72	74
Commercial finance	46	39

In offering many of the activities shown in the table above, banks compete side by side with nonbank providers. If banks had a competitive advantage, they would dominate over other providers. However, in many fields, nonbank providers have a bigger market share than banks. As of December 1996, three out of the top five largest servicers of residential mortgages were nonbanks, and three of the top five originators of mortgages were nonbanks.<sup>52</sup> The Federal Reserve, in fact, has stated persuasively that banks engaging in permissible securities activities do not dominate their respective markets, either.<sup>53</sup>

*Additionally, evidence offered to support the subsidy claim simply does not withstand scrutiny.* Several points cited in support of the existence of a subsidy are: 1) bank debt is rated higher than that of its parent bank holding company; 2) banks hold less capital than other financial institutions; 3) corporations are not leaving the banking business; and 4) bank holding companies are shifting activities from affiliates to banks or bank subsidiaries. In fact, none of these points demonstrates the presence of a safety net subsidy.

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<sup>50</sup> Data as of September 30, 1996. Includes all direct subsidiaries of the bank or holding company. All banks in this analysis were members of holding companies. Source: Federal Reserve Board National Information Center.

<sup>51</sup> Insurance agency or brokerage services related to credit insurance.

<sup>52</sup> "Ranking the Banks: Statistical Review 1996," American Banker.

<sup>53</sup> In its 1987 ruling, "Order Approving Activities of Citicorp, J.P. Morgan, and Bankers Trust to Engage in Limited Underwriting and Dealing in Certain Securities, Legal Developments," the Federal Reserve Board stated, "The Board notes that banks do not dominate the markets for bank-eligible securities, suggesting that the alleged funding advantages for banks are not a significant competitive factor."

First, the small differential between the ratings of debt issued by banks and debt issued by bank holding companies is not due to a safety net subsidy. In 1996, this rating differential resulted in a cost of funds for bank holding companies that was only 4 to 7 basis points higher than the cost of funds for individual banks. According to the rating agencies, the difference is due to the federal banking agencies' ability to use prompt corrective action powers to limit bank payments to the holding company if the bank is undercapitalized.<sup>54</sup> A bank holding company is a shell corporation, with most of its assets held by, and income generated by, the subsidiary bank(s). Reductions in the flow of funds from the banks to the corporate shell decreases the debt-paying capacity of the holding company parent.

The second argument -- that banks hold less capital than virtually all other financial institutions -- is flawed, because it makes no sense to compare capital ratios of different industries in isolation from their relative risk. Also, differences in regulatory capital requirements reflect differences in the regulator's views of the purposes of capital and the different historical risks faced by firms in different sectors. For example, two institutions engaged in very different lines of business could have distinctively different risk profiles. The market would demand a higher equity-to-assets ratio of the firm that holds much riskier assets in its portfolio. Thus, merely comparing the capital ratios of industries in the financial sector to those in other economic sectors is insufficient; and a finding that banks' ratios are lower does not prove that there is a subsidy.

Third, some observers have argued that the fact that corporations are not leaving the banking business is evidence that a subsidy exists. However, various facts about the industry undermine this argument. If there were substantive barriers to entry, no one was leaving the business, and no other factors were at work, banks should experience excessive profits and a growing market share. The facts are not consistent with those implications. Bank profits, while strong in recent years, are not disproportionately higher than other competitors in the financial services industry.<sup>55</sup> Bank stock price-to-earnings (P/E) ratios have averaged only about 60 percent of P/E ratios of other businesses.<sup>56</sup> Also, banks' market share, measured by income-based

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<sup>54</sup> See, for example, Standard & Poor's Bankrating Service. New York, S&P, 1996. Updated quarterly.

<sup>55</sup> According to data presented in the *Property/Casualty Fact Book 1997* published by the Insurance Information Institute, banks had a lower annual rate of return than diversified financial services firms for all but two years in the period 1986 through 1995, the last year for which comparable data are available. However, as is true when comparing capital ratios, it is difficult to make a direct comparison of profits without making a risk-adjustment. In other words, it is difficult to determine whether profits are commensurate with risks undertaken.

<sup>56</sup> According to data by Keefe, Bruyette & Woods, Inc., commercial bank P/E ratios as a percentage of the S&P 500 P/E ratio averaged 62 percent for the six years ending April 15, 1997.

data, has remained flat at least since the late 1950s.<sup>57</sup> Moreover, industry consolidation, which is a form of exiting from banking, is at odds with the existence of a subsidy.

Finally, those who are seeking to prove the existence of a subsidy cite more recent developments as evidence. In particular, they point to a reported drop over the last decade in the share of bank holding company assets held by non-bank subsidiaries, after removing the Section 20 affiliates (firms engaged in Federal Reserve-approved securities activities). The argument seems to be that such a shift is motivated by a desire to exploit a subsidy available to banks and their subsidiaries but unavailable to affiliates of bank holding companies. However, evidence does not support the notion that the shift -- if one has in fact occurred -- is due to a subsidy.

This is true for two reasons. First, it is simply unclear that such an asset shift has actually occurred. There are no current systematic data available to document that a shift occurred. The existing data are problematic for several reasons: Between 1994 and 1995, the Federal Reserve changed the instructions governing the filing of the asset data used in the calculation of the reported shift in order to reduce, if not eliminate, apparently widespread, year-by-year reporting errors. The presence of these reporting errors and the changes in reporting instructions mean that we cannot make accurate year-to-year comparisons. Indeed, the absence of comparability could fully account for the reported drop in the holding company affiliate share of bank holding company assets.

Second, various explanations account for banking organizations moving activities from holding company affiliates to banks and bank subsidiaries. Importantly, over the past decade, the relaxation of geographical and other barriers to interstate banking has permitted banking companies to engage in the interstate conduct of lines of business in banks that they could previously conduct only through holding company subsidiaries. That flexibility could lead banking organizations to shift assets from long-established holding company subsidiaries in those states to banks or bank subsidiaries. Moreover, firms consolidate their operations for many reasons, including the desire for increased efficiency. Recent experience with intrastate and interstate branching demonstrates the efficiency gains of organizational flexibility. Research on intracompany mergers finds that choice of organizational form is an important determinant of the efficiency of a company's operations. These mergers enable banking organizations to streamline their operations and better serve their customers.<sup>58</sup> After many states eased restrictions on intrastate branching, most banking companies responded by consolidating all of their existing subsidiaries into branch banks, although this was not the universal response.<sup>59</sup>

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<sup>57</sup> George Kaufman and Larry Mote, "Is Banking a Declining Industry? A Historical Perspective," *Economic Perspectives*, Federal Reserve Bank of Chicago (May/June 1994), pp 2-21.

<sup>58</sup> Robert DeYoung and Gary Whalen, "Is a Consolidated Banking Industry a More Efficient Banking Industry", *OCC Quarterly Journal*, September 1994.

<sup>59</sup> Robert DeYoung and Gary Whalen, "Banking Industry Consolidation: Efficiency Issues", Working Paper No. 100, The Jerome Levy Economics Institute, April 1994.

## **Conclusion**

Historically, banks have played a special and critical role in our economy as catalysts of economic opportunity in our communities. This role has shifted over the years, both in response to competitive forces and to well-intended and now outdated restrictions that are hindering bank evolution. Technological and competitive forces are continuing to challenge the banking industry, and we must be concerned about the effect of change on the role played by banks in our economy. To preserve banks' critical role, banks must be allowed to prudently diversify their financial and financially related activities. In doing so, each bank should be allowed to choose the organizational form which best suits its needs. Corporate form matters, and to force new activities into the holding company structure will limit the ability of the banking industry to respond to changes in the marketplace and impose unnecessary costs that will render banks less competitive. The bottom line is that, as long as appropriate prudential safeguards are in place, banks should have the choice to engage in a diverse array of financially related activities through their subsidiaries.